

THE PROBLEM OF REORGANIZING AND READJUSTING THE  
CHECK CLEARANCE SYSTEM UNDER THE  
FEDERAL RESERVE ACT.

Washington, D.C.  
October 16, 1915.

To the Federal Reserve Board :

Very early in its history the Federal Reserve Board received applications from certain Federal Reserve Banks which desired to enlarge the scope of the clearance operations in which they were permitted to engage. It freely granted these applications, desiring to encourage initiative on the part of the several Reserve Banks, as well as to convince them that actual business problems were peculiarly their province, and, as such, to be dealt with by them as freely and independently as they chose. Subsequently the whole question of the depositing and clearing of checks with Reserve Banks was considered by Governors of the banks, and various proposals were placed before the Board.

None of these suggestions appeared to meet the requirements of the situation as fully as was deemed necessary, and the Board furthermore found that the work which had been already undertaken by some Reserve Banks, had not in every case been well adjusted to that undertaken by other Reserve Banks, so that there was confusion and uncertainty throughout the system. This was particularly true with reference to inter-district operations.

In these circumstances the Board proceeded to the preparation of a circular relating to the subject of clearance, designed both to unify existing practice, and to confine operations for the present to intra-district transactions, it being understood that for purely inter-district transactions between Reserve Banks, a gold settlement plan was shortly to be introduced, while inter-district clearances between member banks should be deferred. This proposed circular having been sent to them for their criticism, was met by a counter proposal on the part of the Governors to the effect that they would simultaneously, or as nearly simultaneously as possible, establish in the several districts a clearance system which should be uniform in all essentials, although adapted in detail to the peculiar local conditions existing in the various sections. The proposal was accepted by the Board, and drafts of a circular to be sent out by Reserve Banks were presented to it for consideration. These were returned to the Governors without official endorsement by the Board, but the Board took note of the details of the proposed plan, interposed no objection to it, and agreed to withdraw its own plan and observe the operations of that proposed in a friendly spirit.

Under the plan, as thus worked out by the several Reserve Banks, operations were undertaken at dates varying from June 1 to August 1. Some of the results of the system as thus inaugurated were

ascertained through a circular letter sent out during July, and were published in the Federal Reserve "Bulletin" for August, a copy of which is hereto attached. Since the compilation of this statement, there have been additions to and withdrawals from the voluntary clearance system. At the present moment the records of the Board show a record of 2536 member banks all told subscribing to the scheme of voluntary check clearing. Of these about 951 are in the Kansas City District, where the system is mandatory and 363 are in the St. Louis District where the system though started on a mandatory basis is now voluntary so that it would appear that less than 1100 banks have voluntarily accepted the provisions of the clearance plan out of a total of nearly 6700 which might have assented to it.

The question why less than 25% of all eligible banks have voluntarily joined the clearance system established by the Governors of the Reserve Banks in the way already outlined, and why the increase of members is today proceeding so slowly has naturally been a topic of considerable discussion and has been deemed worthy of special investigation. Each Federal Reserve Agent has been requested to discuss the subject by letter, and from the replies sent into the Board, as well as from other data, has been compiled the following review of the problems offered by the clearance system today:

FIRST:

Banks in Central Reserve and Reserve Cities are allowed under the old National Banking Act to hold a large share of the reserve

deposits of other banks. In order to attract these deposits they pay interest upon them ranging all the way from 2% to 7% and in addition, allow country banks making these deposits to charge them "exchange" for the collection of country items. Furthermore, they allow country banks immediate credit on all items, that is checks deposited by them against other banks, even though it may require several days to make collections of these items, and at the same time they make a deferred charge, or a charge only after collection, for all items, sent in by other banks against the account of the correspondent bank. This means that banks in large cities (Central Reserve and Reserve Cities) are carrying a very considerable "float". In other words that a good deal of the so-called "reserves" is and has been really "float"; that is, the items are given immediate credit although they have not been collected.

The opposition to collection at par, comes frequently from city banks, not because city banks find the collection of checks a profitable business per se, but because the collection of checks as a service for member banks has been potent in attracting country bank deposits. These they are unwilling to lose, although they realize that before November 1917, as the law now stands, they are almost certain to lose a large share of these so-called reserve deposits. The immediate enforcement of a gen-

eral clearing system, if such a thing were possible, would reduce at once country bank deposits in Reserve and Central Reserve Cities, thus practically anticipating the provisions of the Act which allowed three years in which to shift Reserve deposits to the Federal Reserve Banks.

There is also opposition from country banks because they will lose the benefit of a collection charge which, in some cases, amounts to 25% of their revenue. As already explained, a country bank is allowed to count as reserves ( i. e. " as amounts due from other banks " ) checks which it has remitted to its correspondent bank, even before the correspondent bank has given the country bank credit for them. Indeed, it has been very truly said, that an extension of this clearing system is really more of a reserve than transit problem.

ANSWER.

This difficulty will be overcome when the requirements in regard to the payment of reserve deposits go into full force. However, the transfer of these deposits to Federal Reserve Banks will not be complete until November, 1917, unless the law is modified meanwhile, which is possible but not very certain. We must discover some solution before that time. One suggestion would be to charge member banks interest

on any deficiency in reserve balances with reserve banks and credit them interest on excess reserve balances. Another way would be by more strict interpretation of reserve requirements as explained later.

SECOND.

It is urged that as every large bank will have to maintain a rather elaborate "transit" department for the collection of checks, until it is relieved entirely of the obligation to perform that service. If the Federal Reserve Banks should clear checks of all member banks, National banks would still, it is argued, be required to maintain transit departments in order to handle the items of State banks which are not members of the Federal Reserve System. That is to say they would have to do so unless the Federal Reserve Banks could find some way of accepting for collection checks, drafts and notes of non-member as well as of member banks.

ANSWER.

This argument is neither very formidable nor sincere for the reason that the expenses of all large transit operations vary directly with the number of items handled. A diminution of the items would therefore reduce the expense proportionately. Furthermore, counsel are in agreement that there is nothing in the law which prevents the acceptance for collection of checks,

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drafts and notes of non-member banks.

THIRD.

It is frequently urged that every bank check is by its terms made payable at the desk of the bank upon which it is drawn, hence that if a Federal Reserve bank debits the reserve account of one of its member banks with checks drawn against it before the bank against whom the checks are drawn has seen them, and without its previous consent, it does so at its peril.

ANSWER.

It might be said with equal force that every check calls for payment of cash at the counter of the payee bank and yet that the use of bank credits has so far developed that such a general demand for cash could not be met. The average bank receives each day in credits about as many items as are drawn against it, "one hand washes the other" and only balances trifling by comparison, must be settled in cash. While practice in this respect has far out run theory, there are involved some difficult questions of interpretation upon which the law is not as explicit as could be wished, hence the thought has prevailed in the Federal Reserve Board that arbitrary methods might lead to confusion and perhaps even to litigation and delay. The real trouble in this case arises largely from bad methods which have been permitted to develop in banking practice. Competition

of city banks for country bank deposits has led not only to payment of high rates of interest on bank deposits, but also to other practices such as the immediate credit on all items received for credit of the depositing bank and deferred debit on items charged against them. This means that country banks have been permitted to count as reserves, balances in excess of their true status. In this connection it is pointed out that if Section 5192 of the U. S. Revised Statutes in regard to reserves was strictly enforced this practice would be largely cured and the opposition of many banks to the clearing of checks through the Reserve Banks would soon melt away. However if this were done without similar action by State authorities we would be placing National banks at some disadvantage.

FOURTH.

A serious obstacle to progress has arisen from the fact that by reason of the depressed business conditions and the plethora of money in many of the banks of the country, accentuated to a large extent by the release of reserves by operation of the Federal Reserve Act, nine of the twelve Federal Reserve Banks have had a hard time to so invest their funds as to earn their operating expenses to say nothing of 6% cumulative dividend, and hence they have been reluctant to adopt a method which might greatly increase their expenses. Some large banks



handle as high as 70,000 to 100,000 items daily and it has been suggested that a Federal Reserve Bank to cover its district completely, might be required to handle even a larger number than this.

ANSWER.

The clearing of items on the books of the Federal Reserve Bank is obviously a far simpler and less complex operation than the conduct of a Transit Department by a large city bank. There is confusion of ideas between clearings and collections. Nobody doubts that if all of the banks belonging to a district chose to do so, they could establish a district wide clearing of checks by the establishment of a voluntary country clearing house. The question, therefore, arises how to induce them to do voluntarily what the law clearly contemplates they shall do and what none of us doubt they could and would do if they so desired. For reasons previously explained, it is important to get a voluntary acquiescence in the clearing system. The adoption of punitive methods is more likely to delay a consummation of results, even though it is recognized that the Board has very considerable powers under Sections 11, 16, and 19 of the Act. But the Board will not get a voluntary acquiescence in the plan by using drastic or punitive measures. The way to make the undertaking a success is to give manifest advantages to the banks which use this method of

check clearing over those which do not. One way of accomplishing this result would be to require all checks to bear a check collection stamp for some small sum - say one cent for checks made payable at par through the Federal Reserve Bank and two cents for checks not so payable. While it is possible that the Federal Reserve Board could, under its broad powers, issue such a regulation to apply to member banks, a general law of this kind applicable to State banks as well as National Banks could not be made except by Congress. Other suggestions intended to give some advantage to the bank joining the voluntary clearing plan and consenting to an immediate charge of checks drawn against it have been considered.

FIFTH:

A serious matter, perhaps the most serious of all occurs from the depletion of reserves below the legal minimum. If a penalty is put upon member banks because their reserve deposits are depleted, they will allege that the depletion of reserves is due to charging their accounts with checks which they have not seen. Even in the moderate way in which we have already entered upon the general clearing of checks, the depletion of reserves has been a very considerable item, and in a few cases in each district, has been sufficient to create an actual deficit. The law gives the Federal Reserve Board authority to enforce a

a penalty against member banks for not maintaining their reserve deposits, but there is some question whether the exercise of this authority would not at once lead banks to file a vigorous protest against the charging of their reserve balances with checks they have not received.

ANSWER.

A solution of this problem seems to lie in the enforcement of the Reserve requirements of the National Bank Act ( U.S. Rev. Stat. 5192) and the reserve requirements and penalties provided in the Federal Reserve law, but that is a drastic remedy which would raise a storm of protest. Another solution which would have a mitigating influence would be to open local agencies in districts and permit funds deposited in distant agencies to be credited on the books of the parent Federal Reserve Bank, much as is done with the subtreasuries in conducting the operation of the Gold Settlement Fund between Federal Reserve Banks. Still another way would be to give one or at most two days deferred debit and credit on all items to give an opportunity for notice and readjustment of balances. However, probably a better solution is that previously suggested - that of charging member banks interest on any deficiency of reserve balances and of crediting them interest on excess reserve balances.

SIXTH:

It is stated by some that the optional plan inaugurated about June 1st has proved a disappointment if not a failure, but it is only fair to say that the optional plan has effected in some Districts at least a reduction and adjustment of exchange charges, so that the true effect under this plan has been more considerable than the actual volume of checks handled would indicate. It is argued with some force that if we can secure the general parring of checks it should not matter what agency handles the transit items. The member banks should be interested only in seeing the most economical plan adopted. To some extent the banks and clearing houses of the country have readjusted their charges to meet the new situation created by the Federal reserve banks, and in one or two country clearing houses have been inaugurated to simplify and cheapen the cost of this service.

ANSWER.

Doubtless much has been learned through operations of the "optional" plan and something has doubtless been accomplished. On the other hand opposition to "clearing" has been solidified and strengthened by hesitation on the part of the Board. It is now time for the Board to attack the problem vigorously or to admit that it sees no solution short of further legislation. Admittedly

the solution is difficult and the opposition strong, but there seems to be nothing insurmountable in the undertaking.

In Conclusion :

The foregoing has been prepared in an effort to review, if not to solve a difficult problem. We are not interested in knowing the obstacles in the way of accomplishing check clearing except to aid us in determining a correct and complete solution. As already stated, hesitation has been taken as a sign of weakness and has encouraged and solidified opposition. It is quite certain, therefore, that after we have thoroughly studied the situation we should take hold of the subject with a more certain grasp.

The bank check is one of the most useful as well as most largely used instruments of credit. It is intended in the Federal Reserve Act that its use shall be facilitated in every possible way; and it is no argument against the check system that some methods have been found of abusing it. The laws of trade and commerce are necessarily based upon honesty, and progress would be very slow indeed upon any other theory. Our effort should be to devise a system which will work well under honest methods and put a severe penalty on those who abuse it by dishonesty or trickery.

Methods proposed for overcoming the difficulties are of course tentative rather than final, and the ultimate solution must be largely worked out in practice by friendly operating officers not by those

who, seeing the difficulties, feel that the problem is hopeless, but by those who, having energy, ingenuity and constructive ability can always find ways of overcoming obstacles.

Speaking generally, there can be very little doubt that if we had fewer districts - say eight or nine instead of twelve - our problem would be simplified. With eight or nine districts we could have a subtreasury in every district and inter-district settlements through the Gold Clearing Fund would be simplified and cheapened. Furthermore, with fewer districts the cost of operating the banks would be lessened and the added burden of check clearing would be less severely felt. An important aid in the accomplishment of the task would be the creation of branches and sub-stations or local agencies for clearing, located at important centers from fifteen to twenty-four hours away from the main Reserve Bank or from each other. With such sub-stations reporting balances by telegraph, transit time and the consequent "float" would be greatly diminished.

(Signed) F. A. DELANO.